

Internal Revenue Service
Office of Federal, State and Local Governments

<http://www.irs.gov/govt/fslg>

FSLG Newsletter – July 2011

This is the semiannual newsletter of the office of Federal, State and Local Governments (FSLG) of the Internal Revenue Service. Our mission is to ensure compliance by Federal, state, and local governmental entities with Federal employment and other tax laws through review activities as well as through educational programs.

For more information, visit our web site at www.irs.gov/govt. For account-related assistance, contact Customer Account Services at 1-877-829-5500. To identify a local FSLG Specialist, see the directory at the end of this newsletter.

The explanations and examples in this publication reflect the interpretation by the IRS of tax laws, regulations, and court decisions. The articles are intended for general guidance only, and are not intended to provide a specific legal determination with respect to a particular set of circumstances. You may contact the IRS for additional information. You may also want to consult a tax advisor to address your situation.

Federal, State and Local Governments

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SECTION 3402(t) WITHHOLDING DELAYED UNTIL 2013

BY STEWART ROULEAU, FSLG TAX LAW SPECIALIST

The IRS released [final regulations](#), published in the Federal Register on May 9, 2011, delaying until after December 31, 2012, the requirement for 3% withholding that will apply to certain payments for property or services made by Federal, state and certain large local governmental units. Section 3402(t) of the Internal Revenue Code sets forth this withholding requirement.

Background

The original legislation in the Tax Increase Prevention and Reconciliation Act of 2005 provided that the withholding would begin after December 31, 2010. The American Recovery and Reinvestment Act of 2009 delayed implementation for one year, until after December 31, 2011. The final regulations have postponed the implementation an additional year, until after December 31, 2012. Thus, government entities are not required to apply the 3% withholding to any payments in 2011 or 2012.

The final regulations provide that, for payment made after December 31, 2012, Federal and state agencies, and governmental subdivisions with annual payments of more than \$100 million, are required to withhold 3% Federal income tax at the time of payment to contractors, vendors, or other persons providing property and services. Government entities are responsible for depositing these amounts.

Government entities will be required to file Form 945, Annual Return of Income Tax Withholding, to report amounts withheld, and to issue Forms 1099-MISC showing the amounts withheld. These Forms 1099-MISC will be furnished to payees, and the payee will claim the amount of tax withheld and shown on the Form 1099-MISC as a credit on its income tax return.

Exceptions

Several exceptions apply to this requirement. For example, the following are not subject to section 3402(t) withholding:

- Wages and other payments to government employees related to their services as employees
- Payments subject to other mandatory withholding
- Interest or repayment of principal
- Real property (but withholding does apply to payments for construction)
- Loan guarantees
- Payments to exempt organizations and other governments
- Grants for a public purpose

- Payments to pass-through entities and corporations with at least 80% ownership by exempt or foreign organizations or other governments or Indian tribal governments

The regulations provide a payment threshold below which withholding does not generally apply. Under the payment threshold rule, individual payments of less than \$10,000 are not subject to the withholding requirement, unless an anti-abuse rule applies. Under the anti-abuse rule, payments divided for the purpose of avoiding the \$10,000 threshold will be regarded as a single payment and withholding applies. The anti-abuse rule will not be applied unless the government entity making the payment knew, or had reason to know, that the payee was attempting to circumvent the payment threshold rules to avoid withholding.

The issue of whether 3% withholding will apply to payments made by payment cards (including credit, debit, stored value, and other payment cards) is still under review. Until further guidance is provided (and at least through calendar year 2013), 3% withholding does not apply to payments by payment card. This exception from withholding for payments by payment card does not apply to convenience checks written on payment card or credit card accounts. For more information on payments by payment card, see [Notice 2010-91](#).

The regulations provide an exception for contracts that are in existence on December 31, 2012. Under these rules, payments made under binding contracts that were in existence on December 31, 2012, and that were not materially modified after December 31, 2012, are excepted from the withholding requirements.

Along with the release of these final regulations, the Service has released proposed regulations that would eliminate the existing contract exception for all payments made after December 31, 2013, regardless of whether there is a material modification to the contract. Comments are requested on the proposed regulations.

More Information

For more information, see the [final regulations](#). See the [proposed regulations](#) for more information on the proposed change to the existing contracts rule.

FSLG AND THE NATIONAL RESEARCH PROGRAM *BY HANS VENABLE, FSLG SENIOR ANALYST (AUSTIN, TX)*

FSLG is currently devoting a significant amount of its examination resources to the Employment Tax National Research Program (ETNRP). ETNRP is a three-year project of the Internal Revenue Service designed to develop data to help

identify sources of the tax gap related to employment taxes. The “tax gap” refers to the amount of taxes that are owed to the Federal Government but have not been paid. The Service developed the concept of the tax gap as a way to gauge taxpayer compliance with federal tax obligations. The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time. It is to the advantage of all taxpayers that everyone pays their fair share of taxes in accordance with the laws enacted by Congress.

The tax gap can be divided into three components: nonfiling, underreporting and underpayment. “Nonfiling” occurs when taxpayers who are required to file a return do not do so on time. “Underreporting” of tax occurs when taxpayers either understate their income or overstate their deductions, exemptions and credits on timely filed returns. “Underpayment” occurs when taxpayers file their return but fail to remit the amount due by the payment due date.

Of these three components, underreporting of income tax, employment taxes and other taxes represents about 80 percent of the tax gap. The single largest sub-component of underreporting involves individuals understating their incomes, taking improper deductions, overstating business expenses and erroneously claiming credits. Individual underreporting represents about half of the total tax gap. Individual income tax also accounts for about half of all tax liabilities.

The tax gap includes significant noncompliance due to tax law complexity that results in errors of ignorance, confusion, and carelessness. The estimate of the tax gap is based on a study conducted to measure the compliance rate of filers based on an estimation of a statistical sample of filed tax returns. ETNRP will provide that data related to employment tax compliance.

ETNRP will include examination of thousands of taxpayers who file Forms 941, including about 500 government entities. Taxpayers are selected on a random basis to allow the IRS to collect information in a statistically valid manner about how taxpayers meet their tax responsibilities. This information will help determine what changes to IRS forms, publications, and tax laws may improve voluntary compliance. It will also be used to guide improvements to how the tax laws are enforced, and to improve programs designed to help taxpayers understand and comply with the tax laws.

ETNRP examinations are conducted in a manner similar to all of the employment tax examinations conducted by IRS. The depth of the examination on a NRP examination is the same as is used in other audits; taxpayers audited in ETNRP are not held to a higher standard or subject to more in-depth audit procedures than others. Issues that are examined include:

- Compliance with information return filing and reporting requirements
- Compliance with worker classification; i.e. whether workers are appropriately classified as employees or independent contractors

- Compliance with provisions of a public entity Section 218 Agreement
- Compliance with taxability of fringe benefits

The examinations of the first 90 governmental taxpayers selected for examination under this program began in 2010 and should be completed within the next few months. 180 governments were selected for NRP examinations for the second year ETNRP cycle. Those examinations began in February 2011 and will continue to open over the next few months. Approximately 230 additional government entities will be selected for the third year ETNRP cycle and will begin in 2012.

WITHHOLDING AGENTS AND FORM 1042-S

BY KEVIN MACKESEY, FSLG SPECIALIST (FEDERAL GROUP)

Government entities who make payments to foreign entities and are potential withholding agents should be aware of Form 1042-S, Foreign Person's U.S. Income Subject to Withholding. This form is similar to Form 1099, W-2, or other information returns that are required to be filed by payers. In general, withholding agents responsible for filing Form 1042-S include individuals, corporations, partnerships, estates, trusts, and all other entities, to whom it paid amounts, as described below, during the preceding calendar year. It is the withholding agent's responsibility to ensure that each Form 1042-S is completed accurately, filed timely, and submitted properly.

Amounts Subject to Reporting on Form 1042-S

Payments subject to reporting on Form 1042-S include amounts paid to foreign persons (including persons presumed to be foreign) that are subject to withholding, regardless of whether any amount is deducted and withheld from the payment because of a treaty or Internal Revenue Code exception to taxation, or whether any amount withheld was repaid to the payee. Amounts subject to withholding are amounts from sources within the United States that constitute (a) fixed or determinable annual or periodical (FDAP) income; (b) certain gains from the disposal of timber, coal, or domestic iron ore with a retained economic interest; and (c) gains relating to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property. Amounts subject to withholding also include distributions of effectively connected income by a publicly traded partnership. Amounts subject to reporting include, but are not limited to, the following U.S. source items:

- Corporate distributions
- Most gambling winnings. However, proceeds from a wager placed in blackjack, baccarat, craps, roulette, or big-6 wheel are not amounts subject to reporting.
- Interest
- Rents

- Royalties
- Compensation for independent personal services performed in the United States.
- Compensation for dependent personal services performed in the United States **(but only if the beneficial owner is claiming treaty benefits)**.
- Annuities, pension distributions and other deferred income
- Amounts paid to foreign students, trainees, teachers, or researchers as scholarship or fellowship income, and compensation for personal services (whether or not exempt from tax under an income tax treaty). However, amounts that are exempt from tax under section 117 are not subject to reporting.
- Amounts paid to foreign governments, foreign controlled banks of issue, and international organizations. These amounts are subject to reporting even if they are exempt under section 892 or section 895.

When Must Form 1042-S Be Filed?

Forms 1042-S, whether filed on paper or electronically, must be filed with the Internal Revenue Service by **March 15**. Taxpayers are required to furnish Form 1042-S to the recipient of the income by March 15. Copy A is filed with the Internal Revenue Service. To request an extension of the time to file with the Service a Form 8809 must be filed.

Withholding agents who file 250 or more forms 1042-S per year must file electronically using the Filing Information Returns Electronically (FIRE) System which operates 24 hours a day, 7 days a week at <http://fire.irs.gov>.

Where are the Forms 1042-S filed?

The 1042-S is filed with the Form 1042-T transmittal to the Ogden Service Center, P.O. Box 409101, Ogden, UT 84409. The Form 1042-T transmittal must be with the Forms 1042-S for the forms to be properly processed.

Withholding Agent Responsibilities

It is the responsibility of the Withholding Agent to prepare, provide and submit an accurate Form 1042-S. To avoid common errors, be sure that you:

- Obtain documentation before the payment is made.
- Determine the appropriate withholding tax amount based on the documented status of the beneficial owner of the payment and eligibility for treaty provisions.
- Withhold and remit to IRS per deposit requirements the proper withholding amount.
- Complete all the required fields on the Form 1042-S. At a minimum, you must enter information in boxes 1, 2, 5, 6, 7, 9, 11, 12a-12d, 13a, 13b, and 16. Other boxes must be completed if the nature of the payment requires it.

- Ensure that gross income you reported in box 2 is not “0”.
- Use only income, recipient, exemption and country codes specifically listed in the Form 1042-S instructions.
- Use only tax rates that are allowed by statute, regulation, or treaty. Do not attempt to “blend” rates. Instead, if necessary, submit multiple Forms 1042-S to show changes in tax rate.
- Use the current year Form 1042-S.
- Attach Form 1042-T to the Forms 1042-S being transmitted. Your name, address, and EIN used on the Form 1042-T should match all the Forms 1042-S.
- File Form 1042, Annual Withholding Tax Return for US Source Income of Foreign Persons, to report all income and withholding amounts reported on all Forms 1042-S and amounts deposited during the year.

The list below shows common errors the withholding agent should avoid:

- Filing the same Forms 1042-S electronically and on paper.
- Showing Federal tax withheld in box 7 that is inconsistent with valid tax rate.
- Show unknown recipient code “20” in Box 13b, but a name is in Box 13a.
- Name in Box 13a inconsistent with recipient code in Box 13b, e.g., name is “pension fund” and code is “individual”.
- No TIN in Box 14, but exemption code in Box 6 is “01” indicating income effectively connected with a U.S. trade or business.
- Box 13e address country of residence is not consistent with country code in Box 16; “OC” and “UC” will create error codes, particularly if treaty benefits are claimed.
- Amount fields are dollars only and right justified, cents can be rounded to whole dollars: under 50 cents round down.

Penalties generally apply to the withholding agent if there is a failure to file correct information returns by the due date (IRC Section 6721), failure to furnish correct payee statements (IRC Section 6722), and failure to file electronically when required to do so. Beginning in August 2011, the IRS will include these penalties for Forms 1042-S filed for tax year 2009 and forward on the Notice 972(CG). The Notice 972(CG) is mailed to payers of record who file their information returns incorrectly. The notice not only explains the proposed penalty allowed by law that IRS can assess for the incorrect filing, but also provides step-by-step instructions on what to do prior to IRS final assessment actions.

You, the withholding agent, are liable for the tax if you know, or should have known, that underwithholding on a payment has occurred. It is also your

responsibility to ensure that each Form 1042-S is completed accurately, filed timely and submitted properly.

Resources

- Instructions for Form 1042-S
- Instructions for Form 1042-T (included on the Form 1042-T)
- Publication 515, Withholding of Tax on Non-Residents Aliens and Foreign Entities
- Publication 1187, Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically
- Form 8809, Application of Extension of time to File Information Returns
- Publication 901, U.S. Tax Treaties
- FIRE (Filing Information Returns Electronically) – <http://fire.irs.gov>

FSLG OFFERS WEBINARS TO GOVERNMENTS

BY TERRY WELCH, PUBLIC AFFAIRS SPECIALIST (WASHINGTON, DC)

With an increasing number of Americans choosing to get their news and information via the web, FSLG Director Paul Marmolejo made the decision last year to offer on-line education alternatives to FSLG customers. Three FSLG webinars - or web seminars - have aired previously, with a third scheduled for July 14.

The [July webinar](#) will focus on recently released Internal Revenue Code section 3402(t) final regulations, which generally require income tax withholding of three percent for payments to contractors beginning in 2013. (See the [article](#) in this newsletter on this topic.) Previous webinar topics have touched on Section 218 Agreements social security agreement, taxation of fringe benefits, and withholding requirements for foreign persons.

Willie Clayton, an FSLG group manager in Maitland, Florida, who oversaw the production of the international webinar on presented in May, said the webinar was a hit among customers. "The feedback was tremendously positive," Clayton said. "People felt the presenters used terminology that took a complex topic and made it simple."

Customer feedback, Clayton added, is essential to the webinar process. "We try hard to discuss the topics our customers need us to cover - and we think we have captured those topics - but we need that customer feedback, to be sure," Clayton said.

Once they have aired live, webinars are made available for viewing at anytime. Links to each webinar, and instructions on how to register for the July 14 seminar, are available at the [FSLG webcast page](#). For questions, suggestions or comments regarding the webinars, please email tege.fslg.feedback@irs.gov

REPEAL OF EXPANDED INFORMATION REPORTING

BY STEWART ROULEAU, FSLG TAX LAW SPECIALIST

The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 eliminated new information reporting requirements that were created by the Patient Protection and Affordable Care Act of 2010 (ACA).

The ACA expanded information reporting requirements, to have taken effect in 2012, to include amounts paid in the course of a trade or business (including operation of a governmental entity), for (1) “amounts in consideration of property,”; (2) “other gross proceeds”, and (3) most payments to corporations that were not previously required to be reported. The new law repeals these additional requirements. You are not required to file Form 1099-MISC for these new categories of payments for any year.

Existing information reporting requirements remain in effect. Payments of \$600 or more for nonemployee compensation made in the course of a trade or business are generally required to be reported on Form 1099-MISC. Certain payments to corporations, including attorney fees or gross proceeds paid to attorneys; payments for medical and health care services, and payments by Federal executive agencies for services are subject to the requirements. See the [Instructions for Form 1099-MISC](#) for more information.

The Small Business Jobs Act of 2010 provided that anyone receiving rental income from real estate would be treated as receiving income from a trade or business of renting property; therefore, information return requirements applicable to small businesses would be in effect. This provision also is repealed; you are not considered to be in a trade or business solely because you receive rental income. See [Publication 527](#) for more information on rental income and expenses.

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